

The institutional environment required to support China's new normal economy

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Abstract The authorities in China have enunciated the development of a new normal economy which henceforth would be the main driver of economic growth and development for that country. The new normal economy would also imply a shift in the economy's structure towards services and its being driven by consumer demand. There would be greater reliance on market competition and the removal of the 'privileges' of state-owned enterprises. This paper argues that it is not enough for the required legal framework to exist in statutes but that they should be observed as law in action. Using a line of reasoning based on New Institutional Economics, evidence drawn from the differing experiences of countries in Central and Eastern Europe, in particular, in their transition towards a market economy and empirical evidence analysing the effectiveness of adopting laws from one jurisdiction in another this paper argues that the success of the new market economy policy will depend not only on the reform of the law on the books but also on how it is implemented through the courts and how it fits with both Chinese legal tradition and culture.

Keywords New normal economy · New Institutional Economics · Transition · Culture · Law-in-action · Transplant

This paper draws on the keynote presentation given by the author at the China-EU School of Law Academic Conference, *Legal Reform of Market Economy*, November 2015, which in turn draws on the author's forthcoming book: *Law and Development: An institutional critique*, Edward Elgar Publishing.

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1 Introduction

The authorities in China have enunciated the development of a new normal economy which henceforth would be the main driver of economic growth and development for that country. The expected rate of growth from this policy (c7%) would be lower than those which have been achieved in recent years (10–12%) but prior rates of growth were no longer sustainable. The new normal economy would also imply a shift in the economy's structure towards services and its being driven by consumer demand. There would be greater reliance on market competition and the removal of the 'privileges' of state-owned enterprises. It has been argued by many including the present writer that market economies require a complex legal foundation.¹ The present paper argues that it is not enough for the required legal framework to exist in statutes but that they should be observed as law in action. Using a line of reasoning based on New Institutional Economics (NIE), evidence drawn from the differing experiences of countries in Central and Eastern Europe, in particular, in their transition towards a market economy and empirical evidence analysing the effectiveness of adopting laws from one jurisdiction in another this paper argues that the success of the new market economy policy will depend not only on the reform of the law on the books but also how it is implemented through the courts and how it fits with both Chinese legal tradition and culture.

The paper is structured as follows: in the next section NIE is introduced and Oliver Williamson's model of levels of social analysis explained and the inter-relationships between institutional environment and culture analysed; the subsequent section analyses the legal component of the institutional environment necessary to support a market economy and how, *inter alia*, culture may constrain the efficiency of the market; the third section examines evidence on the difficulties faced by jurisdictions in the transition to a market economy through an examination of the role which culture played in determining the differential progress made by countries towards establishing a market-oriented economy during the transition period in countries of Central and Eastern Europe in the 1980 and 1990s, reporting on statistical studies showing the importance of enforcement of laws on economic growth across developing and developed countries and finally discussing the effect of receptivity of legal transplants on the effectiveness of transplanted laws; the final section of the paper summaries and draws out the policy implications of the preceding analysis for the legal requirements of establishing a 'new normal economy' in China.

2 New Institutional Economics

What has become known as NIE developed out of an implicit concern with what underpinned the simple model of market exchange which is represented in neoclassical economics. Ronald Coase in his seminal paper *The nature of the firm*²

¹ Stephen 2016.

² Coase 1961.

posed the question of why firms exist, why resources are not all allocated by the market. The existence of firms he attributed to *transaction costs*—the costs of using the market. What Kenneth Arrow³ called the costs of running the economic system. Oliver Williamson took up Coase's idea in the 1970s to develop what he called Transaction Cost Economics. Latterly Williamson has used the term 'Governance' to cover the issues dealt with by this type of analysis.

According to Menard and Shirley transaction costs together with *property rights* and *contracts* are core concepts in the development of NIE.⁴ These three play a crucial part in understanding the role of institutions in society. Below we use Oliver Williamson's levels of social analysis framework to illustrate how NIE can be used to analyse economic development.⁵ The concept of transaction costs is then used to understand difficulties which confronted policymakers who promoted the 'big bang' approach to the transition from an entirely state owned economy to a market economy in Central and Eastern Europe (C&EE) after the fall of the Soviet system in that region.

2.1 Transaction costs and contract

Transaction costs are defined by Dahlman⁶ as:

- Search and information costs (costs of finding someone with whom to contract).
- Negotiation and bargaining costs (costs of arriving at a contract with the other party).
- Enforcement and policing costs (costs of ensuring that both parties deliver on their side of the bargain, particularly where delivery is not instantaneous).

Before Coase neoclassical economics implicitly assumed that market transactions are costless i.e. no resources are used up in the act of exchange. This, however, is only the case in very special circumstances. Very many market transactions incur search costs, bargaining costs and enforcement costs moving contract to a central position in the process of effecting market exchange. However these contracts are neither costless nor necessarily complete. Contractual incompleteness is central to Williamson's work on *Governance*. Under what circumstances does incompleteness occur? How do economic agents deal with it? One way is the creation of a firm: transactional incompleteness explains why some transactions take place within firms yet others take place between firms.

The size of transaction costs is influenced by a combination of human and environmental characteristics (discussed below). The magnitude of transaction costs affects governance structures. Before justifying this we examine the situation in which they are likely to be low which comes closest to the neoclassical assumption that market transactions are costless. Consider the purchase of a standardized good

³ Arrow 1961.

⁴ Menard and Shirley 2014.

⁵ Williamson 2000.

⁶ Dahlman 1979.

for which there are many suppliers and potential consumers. Under such circumstances search costs will be very low: both suppliers and consumers will easily find someone with whom to contract. Because of standardization the characteristics of the good, including quality, are easily ascertainable before purchase. Bargaining costs are negligible because there is little to bargain over (competition determines price). When exchange takes place instantaneously there are no enforcement costs. Looking at these circumstances from a different perspective the assumed market transaction of neoclassical economics is that of a standardized good under conditions of perfect competition where exchange is instantaneous: conceptually ‘perfect competition’ removes search costs; standardization removes search and bargaining costs; instantaneous exchange removes enforcement costs. Thus transaction costs are very small and in the limit are zero.

Absent standardised goods, transaction costs rise due to imperfect competition and bargaining costs are incurred. If exchange is not instantaneous costs will be incurred by both sides: the buyer to ensure that delivery takes place and what is delivered has the characteristics implied by the bargain; or if payment is on delivery the supplier will incur enforcement costs in ensuring payment takes place; and the consumer incurs enforcement costs to ensure what is delivered is what was agreed. When the transaction costs of using the market are sufficiently high the potential buyer may prefer to produce the good itself because transaction costs outweigh any cost advantage that specialised outside production has over self-production. If this did not happen there would be no firms just markets composed of individuals. Inside the firm the market mechanism is suppressed and replaced by managerial direction. Coase (*supra* fn. 4) quotes D H Robertson as describing firms as ‘islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk’.⁷ Coase’s explanation is that these islands of conscious power arise because they lower transaction costs.

Prior to the 1970s vertical integration had been seen as *prima facie* anti-competitive by US anti-trust authorities until Oliver Williamson demonstrated that vertical integration could be efficiency enhancing. This would be the case when the production costs plus transaction costs were lower for a vertically integrated firm than for two firms contracting on the market.⁸ Such circumstances would arise due to a combination of particular human characteristics and transactional features identified by Williamson⁹: the human characteristics of bounded rationality and opportunism; and the transactional features of uncertainty/complexity and ‘the small numbers condition’ (i.e. when there are few potential parties to the transaction).

What do we mean by bounded rationality? Herbert Simon argued that although human behaviour is ‘intendedly rational’ it is ‘only limitedly so’. Neurophysiological limits of the brain and language limitations set bounds on rationality. In many situations economic actors cannot be as rational as neoclassical economics assumes them to be. Opportunism is defined as self-interest seeking with guile which goes

⁷ Robertson 1928, at 85.

⁸ It should be stressed that it is the comparison of the sum of production costs and transaction costs that is relevant here not just the comparison of transaction costs.

⁹ Williamson 1975, 1979, 1985.

beyond the normal economic assumption of self-interested behaviour to include strategic behaviour, threats, information withholding and exploitation of asymmetric informational advantage.¹⁰ Whilst, not all economic agents behave opportunistically, *ex ante* it will be difficult to tell which will. However, potential opportunism is not, by itself, sufficient to raise transaction costs. It requires the presence of one or both environmental or transactional conditions. The first of these is uncertainty or complexity. If all possible outcomes are predictable and there are not too many, a contingent claims contract could be written to cover all possible outcomes. However if they are not, the bounds of rationality will be reached and the contract will be incomplete. Thus the combination of bounded rationality and uncertainty/complexity gives rise to higher transactions costs in the presence of opportunism. Williamson describes the situation where bounded rationality, complexity/uncertainty and opportunism combine as one of information impactedness.

Even so, information impactedness will not on its own be a problem. It requires the presence of the small numbers condition for transaction costs to rise. If *ex ante* there are a number of potential contractors they may compete by revealing information to which the other party does not have access. In situations where the transaction is not one-off but a recurring transaction the incentive to behave opportunistically is also reduced. If a party behaves opportunistically on the first occasion they are unlikely to be awarded the contract on a subsequent occasion unless the initial award gives them a strategic advantage over their competitors. Such an advantage has been termed 'a first mover advantage'.

In other words, the combination of bounded rationality and complexity/uncertainty when there is small numbers and potential opportunism means that a market transaction is risky¹¹ and 'make' rather than 'buy' is preferable. For Williamson the key issue here is small numbers. When does this become crucial? It is when one or more of the parties undertakes transaction specific investment i.e. an investment which is worthless outside the transaction. Under such circumstances the party undertaking the investment is open to opportunistic behaviour on the part of the other party *ex post*. Thus the need to undertake transaction-specific or idiosyncratic investment gives rise to circumstances where vertical integration is preferred to contracting across a market interface. This gives rise to the view that firms and markets are alternative governance structures by which to mediate transactions. If transactions costs are sufficiently high the transaction will not take place across a market interface but within a firm (or other organisational form): the firm will make rather than buy. Thus transaction costs are seen as the major determinants of governance structures.

Another institutionalist was developing his ideas at the same time as Williamson. Douglass North (together with Lance Davies) published *Institutional Change and American Economic Growth* in 1971.¹² Later, North further developed his analysis

¹⁰ Some authors, including the present writer in Stephen 1996, argue that the extension of self-interest seeking to include guile is not necessary to achieve Williamson's results. All that is required is that '...as the relationship unfolds there will be opportunities for one party to take advantage of the others vulnerability... to follow his own interests at the expense of the other party [and]... behave opportunistically', Goldberg 1984, at 129.

¹¹ Victor Goldberg (*op cit*, at 128) uses the term transactional difficulties rather than transaction costs.

¹² Davis and North 1971.

of the importance of institutions for economic growth. Armen Alchian and Harold Demsetz around the same time were working on the analysis of property rights.

These themes developed into what Williamson (1975, *supra* fn. 9) called *New Institutional Economics* (NIE). Today NIE is seen to encompass: transaction cost economics, economics of property rights, the positive theory of agency, relational and incomplete contract theory; new institutional economic history; new institutional political economy; constitutional economics and many more areas. Increasingly, concern with the role of institutions has been incorporated into much of mainstream economics by authors who would not necessarily consider themselves to be a new institutional economist. It is of credit to the pioneers of NIE that what was previously seen as being outside the mainstream has increasingly become mainstream. Indeed, four of the leading writers in the NIE tradition (Ronald Coase, Douglass North, Elinor Ostrom and Oliver Williamson) have been recipients of the Nobel Prize for Economics,

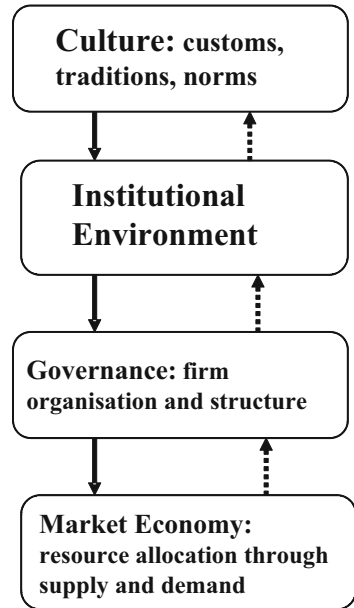
Figure 1 is adapted from Williamson (2000, *supra* fn. 9). The issue of designing a legal system for the ‘New Normal Economy’ is part of the design of the *Institutional Environment*. This sets the context within which economic agents can design governance structures by which resources are allocated. The Institutional Environment is taken to be exogenous to issues of governance as indicated by the solid arrows in Fig. 1. In the longer run there may be feedback from the realm of governance to the Institutional Environment leading to changes in the latter. This may be the case where some aspects of the institutional environment cannot be contracted around to fashion a ‘desirable’ governance structure in some aspect of economic activity.

Williamson’s framework allows us to see the influence which institutions have on economic behaviour. ‘Resource allocation’ is the concern of neoclassical economics: economic agents react to the signals provided by product and factor markets in allocating scarce resources to different activities. In Fig. 1 the solid arrow from the level of *Governance* to resource allocation indicates that resource allocation is constrained by existing ‘governance structures’. Resource allocation takes place on a continuous basis but governance structures take longer to adjust (1–10 years, according to Williamson). Over time governance structures may be adjusted in response to inefficiencies through a feedback loop as indicated by the broken vertical arrow in Fig. 1.

Governance structures are determined by transaction cost as argued earlier and can consist of firms with different organizational and ownership structures, bureaucracies, regulatory bodies, mutuals etc. Transaction cost economics analyses these differing governance structures as arising to minimise transaction costs. Changes in governance structures cannot be instantaneous but according to Williamson (*supra* fn. 9) can take from a year to a decade to change. However, this economising behaviour is itself constrained by the institutional environment within which it takes place as indicated by the solid arrow from Institutional environment level to the governance level in Fig. 1.

In Williamson’s model the *institutional environment* consists of formal rules: constitutions; laws; property rights. As the solid arrow in Fig. 1 indicates changes at this level are constrained by what Williamson refers to as *Embeddedness* which

Fig. 1 Williamson's 'levels of social analysis' Adapted from Williamson 2000



includes informal institutions, norms and religion. However, there may be feedback from the governance level to the embeddedness level. Williamson¹³ refers to the institutional environment as setting the 'formal rules of the game' and governance as the 'play of the game'. The embeddedness level might be seen as providing the *informal* rules of the game. It is non-calculative and spontaneous where what is often called 'culture' operates. Williamson refers to behaviour at this level as being 'adopted' and subject to inertia. A more general name for what Williamson (2000) calls the embeddedness level is culture which is the term used below.

Although it is a relatively simple model, Williamson's framework for social analysis summarised in Fig. 1 highlights the limitations of neoclassical economics as an analytical framework for understanding development policy. What Fig. 1 amply demonstrates is that the transition to a market economy would be heavily constrained by governance structures, the institutional environment and culture. The next section of this paper discusses the importance of the legal system component of the institutional environment necessary for an effective transition to the new normal economy in China.

3 The institutional environment

As discussed above, Williamson (2000) describes the institutional environment as the 'formal rules of the game'. These include the institutions of property, courts, government, regulators. They constrain what is possible at the governance level in

¹³ Williamson 2000.

Williamson's framework through the delimitation of property rights, the law and court system and political structures and are subject to very infrequent adjustment (Williamson suggests 10–100 years). However, the institutional environment is itself constrained by culture. This paper and the conference on which it draws focussed on the law and the court system to which we now turn.

3.1 The legal environment for the new normal economy

All market transactions take place under a set of rules which are either formal or informal.¹⁴ The formal rules are embodied in laws (institutional environment) whilst the informal rules come from social norms and conventions (culture). Both types of rule may be seen as existing to reduce transaction costs (bargaining and enforcement costs). Parties to a market transaction do not have to reinvent the law of contract or social conventions every time they contract. They are bound by them either under the law or by convention.¹⁵ They will expect them to be enforced. They may expend resources (incur transactions costs) to mitigate contingencies which are not dealt with by law or convention or are subject to less predictability of enforcement. To the extent that existing laws and conventions in China do not provide an efficient and effective means for securing transactions under the New Normal Economy's market-driven system higher transaction costs will be generated. Whilst some might see such increased transaction costs as simply the costs of doing business others would argue that they represent a diversion of potentially productive resources (particularly human resources) into 'non-productive activities' and consequently reduce economic growth. Could laws more appropriate to a market context reduce these transaction costs? This leads to the suggestion that laws which have been shown to be effective or even efficient in jurisdictions in which the market economy is established should be incorporated into the Chinese legal system. However, the analysis presented earlier in this paper should caution the reader against the presumption that such legal transplanting is easily accomplished.

It was argued above that the institutional environment is constrained by culture and that the institutional environment consists of more than the legal system. There is an extensive literature on the effectiveness of legal transplants as well as on whether there are legal rules which are best at supporting a market economy (see further below). The next section of this chapter draws on empirical evidence from these literatures to inform the discussion on the legal framework required for a successful transition to the New Normal Economy in China.

A further dimension to this discussion is also provided by considering not only the content of the law but also whether it is effectively enforced. This is pithily expressed by the maxim that 'It is the law in action that matters not the law in the books'. A set of legal provisions contained in a statute may be judged to be jurisprudentially perfect but have no effect if the jurisdiction's courts either cannot be relied on to enforce them or take decades to deal with disputes under these statutes. The reform of courts or the judicial system may be just as important for

¹⁴ Or both.

¹⁵ Under common law they may be able to contract around contract law provisions.

implementing a legal system to support the new normal economy as reforming the content of specific laws. The next section of this chapter draws on evidence of the importance of enforcement both relative to the content of laws but also what factors seem to influence whether or not transplanted laws will be effectively enforced.

4 Evidence

In this section evidence of the importance of culture, enforcement and receptiveness of transplants is drawn from the literature. First the importance of differences in culture is used to explain the differences in the speed of the transition to a market economy experienced in Central and Eastern Europe (henceforth C&EE) since the 1990s. Secondly, evidence of the importance of enforcement of laws by the courts for economic growth across a range of countries is presented. Thirdly, the role played by receptivity to legal transplants is illustrated by again considering the transition towards a market economy in the countries of C&EE at the end of the twentieth century.

4.1 Transition in Central and Eastern Europe: the importance of culture

The collapse of the Soviet system and the ensuing transition of the economies of Central and Eastern Europe to market economies provide a rich source of evidence on the importance of institutions in underpinning the market economic system. Svetozar (Steve) Pejovich analyses of the role played by cultural differences on the transition process across a range of Central and Eastern European jurisdictions.¹⁶ He provides persuasive evidence on how a mismatch of culture and imported (imposed) institutions can raise transaction costs diverting resources from productive activity to activities to circumvent or undermine the transition process and inhibit economic growth or to slow down the adoption of new institutions.

In Pejovich's (2003) view the transition process was intended to 'transform...[C&EE countries]... into free market, private property economies'. This was to be achieved through: privatization; macro-economic stability; and the liberalization of prices and wages. He describes the transition as mixing the culture of C&EE countries with the formal institutions of capitalism. The outcome of this combination was an increase in transaction costs because:

- economic agents are not adapting to the new institutional environment and consequently are spending more time and resources to undertake contracting activity; or
- the newly established institutional environment is not properly functioning and is costly to operate; or

¹⁶ Pejovich 2003, 2008. For a more general discussion of the failure of neoclassical economics to explain the differential responses of countries to the transition process and the insights gained from New Institutional Economics see Berglöf and Roland 2006.

- the new institutional environment is incompatible with the prevailing culture and as a consequence resources are being used up by trying to contract around the new institutional structure; or
- there is cultural resistance to the changes in the institutional environment.

Pejovich focuses particularly on the last of these reasons to explain the differential success of the transition process across the countries of C&EE.

When elements of the institutional environment are adopted/imposed/transplanted from another society there is the potential for a clash with existing practices which may be deep-rooted or culturally-based. As Pejovich points out, although the institutional environment may be a policy variable under the control of policymakers culture is not. Informal rules or norms may impede the effective implementation of formal rules (institutions).

Thus in some jurisdictions in C&EE there was sufficient unhappiness with the new formal rules (or the true costs of using them) that economic agents sought to evade them or disobey them or to resist their introduction. This led to higher transaction costs of enforcing the formal rules or slowed the pace of reform. These higher transaction costs drew resources away from productive activity and thus reduced the growth which would be obtained from reallocating resource to higher valued activities.

Pejovich attributes the lack of harmony between the formal rules adopted in transition countries and the informal rules/norms in some C&EE countries to a clash between the culture of these countries and the culture of capitalism. He sees the transition process as replacing the institutions of socialism with those of capitalism which he summarises as including: private property rights; freedom of contract; an independent judiciary; a constitution. These, of course, are elements of the institutional environment. Pejovich argues that transaction costs will be lower in a society where these institutions are combined with a culture which emphasises individualism through: self-interest seeking; self-determination; self responsibility; risk taking; market competition. On the other hand, he sees the culture of C&EE countries as predominately involving: collectivism; egalitarianism; extended family; shared values. There is a cultural clash between this culture and the culture of capitalism. More importantly these cultural values do not fit so readily with the institutional environment of capitalism and result in increased transaction costs because economic agents resist the new institutions or seek ways to circumvent them.

Pejovich (2008) uses the Heritage Index of Freedom¹⁷ as a measure of the extent to which a country's institutional environment reflects the institutions of capitalism. It is higher when a country's institutions are further away from those of capitalism. He uses historical influences of both religion and membership of former empires to categorise C&EE countries into those whose cultures have been influenced historically by Western culture and those influenced by Eastern culture. Western culture is signalled by having been a part of the Austro-Hungarian Empire and/or

¹⁷ The Heritage Foundation's *Index of Economic Freedom* is published jointly by the Heritage Foundation and the Wall Street Journal.

being predominately Catholic or Lutheran historically.¹⁸ Eastern culture is proxied by having been part of the Ottoman or Russian Empires or predominately Orthodox or Muslim.¹⁹ The Index of Freedom is higher for the countries which he classifies as of eastern culture compared to those classified as of western culture both in 1996 and in 2006.²⁰ For both groups the index falls between these dates but the gap between the groups is maintained. Pejovich (2008) concludes from this evidence that there was greater resistance to the introduction of the institutions of capitalism in the eastern influenced countries but while it was being gradually overcome in both groups of countries, the resistance was more prolonged in eastern influenced countries.

This evidence from the transition process in Central and Eastern Europe is consistent with the Williamson's (2000, *supra* fn. 9) model. It demonstrates that culture constrains the institutional environment. It should be noted that this does not examine *actual* economic performance across transition countries but only the introduction of what Pejovich calls the institutions of capitalism. Even where these institutions have been introduced their impact may be affected by higher transactions costs if (for cultural reasons) actors in the economy use resources to contract around them.

4.2 Content versus enforcement of laws

Over the last twenty years or so a large literature has developed examining the relationship between the content of laws, particularly, on corporate governance and the economic performance of a jurisdiction which was stimulated by a series of papers by the economists La Porta, Lopez-de-Silanes, Shleifer and Vishny²¹ in which they argued, *inter alia*, that the Common Law jurisdictions provide better protection for investors in companies than do Civil Law jurisdictions and that enforcement was more effective in Common Law jurisdictions.²² Subsequent papers challenged the empirical evidence adduced by these authors to support these claims but others extended their conclusions by looking at the relationship between corporate laws across jurisdictions and economic performance. This literature is extensively reviewed in the present author's forthcoming monograph (see fn. 1 above).

While these results remain controversial, both national governments and multilateral development agencies (such as the World Bank) have undertaken programmes of law reform stimulated by the view that the content of Anglo-American investor protection and bankruptcy laws are efficiency enhancing and

¹⁸ These were: Estonia; Lithuania; Latvia; Czech Republic; Slovakia; Hungary; Slovenia; Poland; Croatia.

¹⁹ These were: Bulgaria; Moldova; Albania; Russia; Ukraine; Romania; Belarus; Macedonia; Bosnia-Herzegovina.

²⁰ Pejovich 2008 does not present any tests for the statistical significance of the differences between the means but the present writer has verified that the differences are statistically significant.

²¹ La Porta et al. 1997, 1998.

²² This sometimes referred to as 'legal origin theory'.

thus promote economic growth. To some extent the reform strategies have also incorporated attempts to improve the efficiency and effectiveness of the regulatory and court systems. Whilst it is a matter of logic that even the best laws will have no effect if they are not enforced by the courts the relative importance of content and enforcement has been relatively neglected. An analysis by the present writer and Stefan Van Hemmen²³ using similar data as LLSV (1998) supplemented by other data on the financial sector and allowing their measure of enforcement to interact with their measures of legal content found results which suggest:

- the greater the size of the financial sector the greater is economic growth;
- both major components of the financial sector (size of stock market, amount of bank lending) are affected both by the content of laws and the effectiveness of enforcement; but
- in the case of stock market capitalisation the interaction of the legal content measures and the enforcement measures suggests that for:
 - countries where the level of enforcement is poor²⁴ only improvement in enforcement of the law is what matters;
 - countries where enforcement is at reasonable level²⁵ improvement in both enforcement and the content of shareholder protection laws is desirable; and
 - countries where enforcement is already high²⁶ only improvement in the content of the laws matters.

These studies suggest that while the content of laws is an important factor in determining economic development, improvement in the judicial system is also important and in some cases more important.

4.3 The transplant effect

In parallel to, and to an extent in response to, the development of legal origin theory a literature examining empirically the impact of legal transplants has also developed.²⁷ There is also a literature in comparative law where there has been a debate between those who argue that legal transplants are not possible and those who argue that not only are they possible but that all legal systems incorporate transplants. This paper is not the place to engage in the wider conceptual debate and will focus on the empirical evidence of the impact of legal transplants generally and the transition countries of Central and Eastern Europe in particular.

²³ Stephen and Hemman 2004. This statistical analysis is extended further in the present writer's forthcoming monograph (fn. 1 *supra*).

²⁴ Nigeria, Pakistan, Philippines, Zimbabwe and possibly Colombia.

²⁵ Indonesia, Egypt, Argentina, India, Turkey, Mexico, Israel, Brazil, Greece, Chile, Thailand, Korea, Malaysia and Spain.

²⁶ Portugal, Singapore, Italy, Taiwan, France, United Kingdom, Japan, Australia, Canada, Germany, USA, Finland, New Zealand, Denmark, Netherlands, Belgium, Sweden, Austria and Norway.

²⁷ See in particular Berkowitz et al. 2003, Pistor et al. 2000, 2003.

Katherina Pistor and a number of collaborators have combined knowledge of laws across jurisdictions with economic analysis and econometric estimation techniques to analyse what factors have been key in the success of legal transplants. They conclude that the process of transplanting is more important than the content of the code being transplanted. It is this that determines the effectiveness of enforcement (which they call 'legality'). To be effective law must be meaningful in the context of application. Legal actors must increase the quality of law in response to a demand for legality. Legal cultures already exist where transplants take place. Sometimes the legal culture may be based on informal norms and rules as well as formal rules. These authors make the point that effectiveness requires rules to be interpreted and understood. When transplants take place gaps in understanding and interpretation may arise and transplants need to be adapted to the local context of the recipient jurisdiction. 'Receptivity' is the term used here to indicate the willingness to give meaning to imported law. It will be greater the more the transplanted law is adapted to local conditions and the more familiar legal agents are with the legal order from which the transplant comes.

Legal transplants may occur for a number of reasons: conquest; colonial settlement; conditionality; emulation. Perhaps the majority of legal transplants have taken place through conquest e.g. Roman Law throughout Europe during the period of the Roman Empire until the Napoleonic code was spread through continental Europe as well as French and Spanish colonies in the nineteenth century. A distinction is made between conquest and colonial settlement to reflect the difference between French and Spanish colonies which were essentially extractive in nature and the British colonies to which settlers took the common law e.g. North America, Australia, New Zealand, Southern Africa. Conditionality refers to the case where a legal transplant takes place as a condition for some other activity e.g. accession to the European Union. Emulation refers to transplants which result from the receiving jurisdiction wishing to import laws which they believe to be desirable for them to adopt. e.g. for the purpose of comprehensively modernising the economy as an act of sovereignty.

The authors cited in fn. 27 argue that the success of a transplant is not merely dependent on the reason for it taking place. They argue that what is important is adaptability and familiarity. Is the transplant adaptable to local conditions? Are local legal actors familiar with what is being transplanted? Familiarity can come from frequent contact with the legal system of origin which will be enhanced if the receiving jurisdiction's legal order has similarities to that of the transplant's origin. In order to make their hypothesis empirically testable the authors devise the concepts of *receptive* and *unreceptive* transplants. Their hypothesis is that legality (their measure of enforcement) will be greater for receptive than for unreceptive transplant. They further hypothesise that the higher the level of legality the greater will be the impact of the legal system on income per capita in the jurisdiction. There is an obvious link with the research of Stephen and Van Hemmen discussed above.

Pistor, Raiser and Gelfer (*supra* fn. 27) examine data for 24 transition countries of Central and Eastern Europe, the Baltic States and the Confederation of Independent States. Here the focus is on stock market capitalisation and creditor rights (as in Stephen and Van Hemmen, *supra*) i.e. the financial sector and the

influence of shareholder and creditor protection laws. The authors judge the laws on the books covering these issues in some countries to be of a high standard. Of particular interest is their finding of a strong correlation between receptive transplants and various measures of enforcement. Overall their results support the view that enforcement is more important than the content of investor and creditor laws (which appear to have little effect) in promoting stock market capitalisation and bank lending.

Berkowitz et al. (2003, *supra* fn.27) use data from 39 countries who were historically recipients of legal transplants to test for the effects of legal origin and legality on income per capita as well the influence of legal origin and transplant receptivity on legality. Thus legal origin has a direct effect and an indirect effect on income per capita, the indirect effect being through legality but legality is also affected by whether the transplant from the legal origin is judged to be a receptive or unreceptive transplant. Their statistical results suggest that the direct effect of legal origin on income per capita is higher for French and German legal origins than other legal origins and that the higher is their measure of legality the higher is income per capita. However, the indirect effect of legal origin on income per capita (through legality) is such that French legal origin has a negative effect and unreceptive legal transplants have a negative effect. The indirect negative effect of French Civil Law origin is such that it cancels out the positive direct effect. For present purposes the important result is that legality (which we have called enforcement earlier) is lower for unreceptive transplants than for receptive ones and as a consequence income per capita will be lower, *inter alia*. These results suggest that there must be a demand for a transplant (as well as a supply) for it to be effective. They also add weight to the view that enforcement is probably more important than the content of the law.

4.4 Summary of evidence

What insights can be gained from the evidence examined in this section? It is more than suggestive that the content of laws designed to support the market do not have the decisive effect. Enforcement is of major importance. Laws which clash with local culture will be resisted and circumvented by various means. Where laws are transplanted from foreign legal cultures a demand must exist for them to be implemented successfully. This implementation is likely to be more successful the more familiar local legal actors are with the legal order from which the transplants come.

5 Summary and conclusions

This paper has considered issues relevant to the design of a legal regime to support the Chinese authority's objective of moving towards the New Normal Economy. It has used the conceptual framework of NIE to argue that the legal system as an element of the institutional environment constrains governance and the play of the market economy but is itself constrained by culture. As well as conceptual argument this approach has been supported by reviewing empirical evidence on the influence

of culture on the economic transition in the countries of Central and Eastern Europe, the importance of enforcement of laws (as opposed to their content) governing investor and creditor protection on economic development and the significance of receptivity in determining the effect of transplanted laws.

The implications of this analysis for legal policymakers in China is that when considering reform of laws governing market activity attention should be paid to the legal order from which any legal transplants come to improve their receptivity as well as their fit with Chinese culture. Furthermore a high priority should be given to reform of the judicial system in ways that will make the law more predictable and effective.

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